

Internal Revenue Service
Appeals Office

Department of the Treasury

Release Number: **201129054**
Release Date: 7/22/2011
Date: February 16, 2011

Employer Identification No.:

A

Person to Contact:

Employee ID Number:

Tel:

Fax:

ADDRESS

Form Required to be Filed:

Tax Years:

forward

Certified Mail

Dear

This is a final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code (IRC). It is determined that you do not qualify as exempt from Federal income tax under IRC Section 501(c)(3), effective January 1, 2006.

Our adverse determination was made for the following reason(s):

Based on the examination of your records, it has been determined that you do not meet the requirements of an organization described under section 501(c)(3). You are not operated exclusively for charitable, educational or any other exempt purposes. You did not engage primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3). More than an insubstantial part of your activities were in furtherance of a non-exempt purpose. You are operated for a substantial private purpose because you are operated for the benefit of private, rather than public, interests.

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on the form indicated above. You should file these returns within 30 days from the date of this letter, unless a request for an extension of time is granted. File the returns in accordance with their instructions, and do not send them to this office. Processing of income tax returns and assessment of any taxes due will not be delayed because you have filed a petition for declaratory judgment under Code section 7428.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Claims, or the district court of the United States for the District of Columbia must be filed within 90 days from the date this determination was mailed to you. Contact the clerk of the appropriate court for rules for filing petitions for declaratory judgment. To secure a petition form from the United States Tax Court, write to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process. The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the US Tax Court. The Taxpayer Advocate can however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. See the enclosed Notice 1214, *Helpful Contacts for your "Notice of Deficiency"* for Taxpayer Advocate telephone numbers and addresses.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Karen A. Skinder, Appeals Team Manager

Enclosure: Notice 1214 *Helpful Contacts for your "Notice of Deficiency"*



TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
TE/GE EO Examinations
1500 Ormsby Station Court Suite A-Stop 700
Louisville, KY 40223

January 22, 2011

ORG
ADDRESS

Taxpayer Identification Number:
Tax Year(s) Ended:
Person to Contact/ID Number:
Contact Numbers:
Telephone:
Fax:

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies.

Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,



Renee B. Wells, Acting Director
Exempt Organizations
Examinations

Enclosures:
Publication 892
Publication 3498
Report of
Examination

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

Legend

ORG - Organization name XX = Date Motto = motto CPA = CPA POA = POA Treasurer
= treasurer RA-1 & RA-2 = 1st & 2nd RA CO-1, CO-2, CO-3 & CO-4 = 1st, 2nd, 3rd & 4th
COMPANIES

Issue:

Whether ORG (ORG) continues to meet the requirements of Internal Revenue Code (IRC) section 501(c)(3), and therein continues to qualify for exemption from Federal income tax.

Facts:

ORG was granted tax-exempt status as an IRC 501(c)(3) in January, 19XX.

During the years in question, ORG's primary activity was the operation of a weekly motto. At the motto, pull-tabs were also sold.

At the mottos, the workers were required in sign-in. The sign-in sheets contained two columns labeled "Name" and "Team/Group." Marks were also made on the sign-in sheets such as "left early 3/4 share", "1/4 share", "TC Dance = 1", "KE = 11", "HC = 1", "KE = 12", "Girls Soccer HC = 10 %", "FBLA = 3" and other marks that summarizes the groups that worked.

On May 21, 20XX, an interview was conducted with the Treasurer, Treasurer. Treasurer stated the following.

- The Form 990 for 20XX that was filed contains some additional financial information that does not belong to ORG. The books were kept by CPA and contain a small amount of fundraising activity for another organization.
- Prior to the audit ORG did not issue and Forms W-2, W-2G, or 1099-Misc.
- The primary activity of the organization is motto.
- The athletic director makes the determination on what athletic team receives funds from ORG.
- ORG does not have any formal discussions concerning the activities or financial transactions. The discussions are usually in the hallway or by telephone.
- No documentation or formal approvals for fund disbursements exists.
- Only one meeting is held each year with very brief minutes being kept.
- Parents and children of different organizations work the motto for ORG.
- There is no direct compensation to a certain group based off of the amount of motto that was worked.
- This organization does not have a reward system for the workers.
- Treasurer is paid \$ per month for her duties as Treasurer. She prepares the quarterly reports, Forms 990, maintains the checkbooks, and other related duties.
- CPA is the primary motto operator.

On May 21, 20XX (later in the day), a telephone call was placed to Treasurer from POA (Power of attorney) office.

- Treasurer stated that there is no formal or informal policy that other organizations receive money for working motto. It is assumed that if you help, you get money.
- Treasurer did not know what the shares and other marks on the sign-in sheets indicated. She stated that CPA should know.

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

On July 9, 20XX an interview was conducted with CPA, Motto Chairperson / Secretary, and POA, POA, was also present. The interview was conducted at POA office. The following statements were made by CPA.

- She was the motto chairperson and Secretary for ORG in 20XX & 20XX.
- She attended every motto.
- She attended the mottos as a volunteer.
- She would ask friends and people affiliated with ORG to work motto. Some of the workers were ROTC, soccer, basketball, and CO-1.
- She guesses that she was in charge of the mottos.
- She recently went through a divorce and can not really remember that much.
- She does not know what the shares and other marks on the motto sign-in sheets indicated. She stated that Treasurer would know.
- She stated that on the checks, the Memo "January CPA" and "Correction to Jan Feb CPA" meant that CPA dropped the checks off to the front desk of CO-1 Training Center.
- Her daughter belonged to CO-1.
- During that time, CPA's husband was loaded and CPA always paid the fees related to her daughter's expenses at CO-1.
- CPA did not have to work fundraisers to get credits.
- She guesses that CO-1 had individual accounts.
- She did run a Pizza fundraiser at CO-1 and did not know if a portion of the sales went into the account of the seller. She suggested that I speak with RA-1 to find out what happens to the money that CO-1 receives from ORG.
- It was up to the ORG Board if other organizations received money in exchange for working motto. It was out of her control.

During 20XX, ORG conducted approximately 34 Sessions. During 20XX, ORG conducted approximately sessions

Gross Receipts were as follows:

Year	Motto	Pull-tabs	Total
December 31, 20XX	\$	\$\$	\$\$
December 31, 20XX	\$\$	\$\$	\$\$

ORG used a motto work force from multiple different tax-exempt and a for-profit organization. In exchange for working a mottos, the organization that provided workers would receive a donation. This donation was based off of the net profit of the motto.

CO-2 (CO-2) is a for-profit group that was the primary motto force in the years in question. Members of CO-2 received a portion of the donation placed into the individual accounts. These accounts were used to offset the cost of being in gymnastics.

In 20XX, ORG wrote checks labeled as "donations" to other entities in exchange for working motto. The total amount was \$\$.

In 20XX, CO-2 received checks totaling \$\$ from working the mottos. This is % of the total donations. According to the sign-in sheets, CO-2 provided % of the workforce.

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

In 20XX, ORG cheerleaders received checks totaling \$\$ from working the mottos. This is % of the total donations. According to the sign-in sheets, ORG Cheerleaders provided % of the workforce.

In 20XX, CO-3 received checks totaling \$\$ from working the mottos. This is % of the total donations. According to the sign-in sheets, CO-3 provided % of the workforce.

In 20XX, CO-4 received checks totaling \$\$ from working the mottos. This is % of the total donations. According to the sign-in sheets, CO-4 provided % of the workforce.

On January 25, 20XX the Office of Charitable Gaming issued a Notice of Violation to ORG. The violation stated, "During the 2nd Quarter of 20XX, the organization donated to CO-2, CO-1, \$\$ for working their game. In addition, CO-2 is not known to possess a charitable tax exempt status." ORG was fined \$ for this violation.

On July 23, 20XX, an interview was held with the RA-2. RA-2 is the record keeper for CO-2. RA-2 indicated that CO-2 would receive a check from ORG along with a list of people that worked the mottos. Credits would be applied to the individual workers accounts. The accounts are used to offset the personal expenses associated with being in gymnastics.

Documentation concerning the exempt and non-exempt activities was requested for ORG.

ORG was unable to provide any documentation concerning the tax-exempt activities of the organization. ORG does have one meeting per year and provided the minutes from the meeting. The primary discussion was motto related.

At the mottos, the average workforce was made up of 11 people (taken from the sign-in sheets). These individuals would sell the pull-tabs, sell motto paper, sell motto computers, and handle the session records. ORG also paid a security guard, a janitor, and Treasurer handled the books.

In State, all workers involved with charitable gaming must be volunteers.

As of the writing of this report, the Form 990 for the year ended December 31, 20XX has not been filed.

Law:

Section 501(a) of the Internal Revenue Code exempts from taxation organizations described in subsection (c) or (d) under this subtitle unless such exemption is denied under section 502 or 503.

Section 501(c)(3) of the Code exempts from taxation: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office."

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable, educational, or scientific purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

Treasury Regulation 1.501(c)(3)-(a)(1) provides, in part, that: "In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt."

Section 1.501(c)(3)-1 of the Income Tax Regulations provides:

(c) Operational test--(1) Primary activities. An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the Income Tax Regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) provides that the burden of proof is on the organization to establish that it is not organized and operated for the benefit of private interests.

Church in Boston v. Commissioner, 71 T.C. 102, 107 (1978), provides, in part, that the word "exclusively" does not mean "solely" or "without exception." An organization which engages in nonexempt activities can obtain and maintain exempt status so long as such activities are only incidental and insubstantial. (World, Family Corp. v. Commissioner, 81 T.C. 958, 963 (1983)) Neither the Internal Revenue Code, the regulations nor the case law provide a general definition of "insubstantial" for purposes of 501(c)(3). This is an issue of fact to be determined under the facts and circumstances of each particular case. (World, Family Corp. v. Commissioner, supra at 967.)

In Make a Joyful Noise, Inc. v. Commissioner, 56 TCM 1003 (1989), the court held that operating regularly scheduled motto games on behalf of other exempt organizations was a trade or business unrelated to the organization's exempt purposes.

In that case, the court concluded that the petitioner failed to carry its burden of proving that its participation in motto games was an insubstantial part of its activities.

In P.L.L. Scholarship Fund, v. Commissioner, 82 TC 196 (1984) the Tax Court held that petitioner was not operated exclusively for exempt purposes under the provisions of section 501(c)(3), I.R.C. 1954, and section 1.501(c)(3)-1(c)(1), Income Tax Regs. Therefore, it is not exempt from Federal income tax.

Petitioner was incorporated as a nonprofit corporation for the purpose of raising money to be used for providing college scholarships. The money was raised from the operation of motto games on the premises of a commercial establishment.

The court stated that: "After careful consideration of the entire record, this Court finds that the petitioner has not carried its burden of showing that it was operated exclusively for an exempt purpose under the required standards."

The court further stated that: "Since the record in this case does not show that the petitioner was operated exclusively for exempt purposes, but rather indicates that it benefited private interests, exemption was properly denied."

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

In People of God Community v. Commissioner, 75 TC 127 (1980), the court held, that part of petitioner's net earnings inured to the benefit of private shareholders or individuals and that petitioner was not exempt as an organization described in section 501(c)(3), of the Internal Revenue Code of 1954.

The court stated that the burden falls upon petitioner to establish the reasonableness of the compensation. The court indicated that by basing compensation upon a percentage of petitioner's gross receipts, apparently subject to no upper limit, a portion of petitioner's earnings was being passed on to an individual.

The court stated that: "The statute specifically denies tax exemption where a portion of net earnings is paid to private shareholders or individuals. We hold here that paying over a portion of gross earnings to those vested with the control of a charitable organization constitutes private inurement as well. All in all, taking a slice off the top should be no less prohibited than a slice out of net."

Revenue Ruling 69-383, 1969-2 CB 113, (Jan. 01, 1969) provides in part that, under certain circumstances, the use of a method of compensation based upon a percentage of the income of an exempt organization can constitute inurement of net earnings to private individuals. For example, the presence of a percentage compensation agreement will destroy the organization's exemption under section 501(c)(3) of the Code where such arrangement transforms the principal activity of the organization into a joint venture between it and a group of physicians (Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958)), or is merely a device for distributing profits to persons in control (Birmingham Business College v. Commissioner, 276 F. 2d 476 (1960)).

Christian Echoes National Ministry, Inc. v. United States, 470 F.2d 849 (1972), held, in part, that "tax exemption is a privilege, a matter of grace rather than right".

In accordance with the statutory recordkeeping requirement, an organization must keep records adequate to determine the full nature of its operations and show that its net earnings do not inure in part to the benefit of private individuals. Church of Gospel Ministry v. United States, 640 F. Supp. 96 (D.C. Cir. 1986) (Missing funds and lack of adequate records made it impossible for organization to meet its burden of showing that its operations were primarily for religious or charitable purposes and that nothing inured to the benefit of its members, and provided independent grounds for rejecting its claim to tax-exempt status).

Revocation is appropriate in a case where the organization fails to maintain any records or maintains inadequate records. Without adequate records the organization cannot carry its burden that no part of the organization's net earnings inure to the benefit of private individuals. Freedom Church of Revelation, 588 F. Supp. 693 (D.C. Cir. 1984) (The organization failed to provide any information on its operation and finances, failed to provide sufficiently detailed evidence as to the nature of its charitable disbursements, and the information submitted was insufficient to demonstrate positively that a portion of its earnings did not inure to private individuals); Western Catholic Church Commissioner, 73 T.C. 196 (1979), aff'd, 631 F.2d 736 (7th Cir. 1980), cert. denied, 450 U.S. 981 (1981) (No bookkeeping procedures were instituted despite advice from organization's accountant that inability to document what happened to the money would be troublesome if the organization was audited).

The presence of a single substantial nonexempt purpose can destroy the exemption regardless of the number or importance of exempt purposes. Better Bus. Bureau v. United States, 326 U.S. 279, 283, 90 L. Ed. 67, 66 S. Ct. 112 (1945); Am. Campaign Acad. v. Commissioner, 92 T.C. 1053, 1065 (1989); see also Old Dominion Box Co., Inc. v. United States, 477 F.2d 340 (4th Cir. 1973), cert. denied, 413 US 910 (1973) ("operating for the benefit of private parties who are not members of a charitable class constitutes a substantial nonexempt purpose"). When an organization operates for the benefit of private interests, such as designated individuals, the creator or his family, or persons directly or indirectly controlled by such private interests, the organization by definition does not operate exclusively for exempt purposes. Am. Campaign Acad. v. Commissioner, supra at 1065-1066.

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

Taxpayer's Position:

On a conference call (November 18, 20XX), ORG indicated that they may agree to the revocation.

On a letter dated December 1, 20XX, the POA indicated that ORG will be appealing the issues.

"We are in receipt of your November 18, 20XX letter on the above named entity. After consultation with the officers and directors, they have chosen not to accept your settlement proposal in this case. They do not feel since they are shutting down and have turned in their gaming license that they should have to revoke their tax exempt status back to January 1, 20XX."

Government's Position:

Based off of the information that you have furnished, % of ORG's time and financial activity was devoted to charitable gaming activities.

At the charitable gaming sessions, 100% of the workforce was compensated.

During 20XX & 20XX, 100% of the income came from the charitable gaming operations. These charitable gaming operations are not related to an exempt activity and are a source of unrelated business income.

During 20XX & 20XX, 100% of the time was devoted to charitable gaming operations. These charitable gaming operations are not related to an exempt activity and are a source of unrelated business income.

Gross income from you exempt function activities was \$. % of your gross income came from your charitable gaming activities.

You are operated similar to the organizations described in Make a Joyful Noise v. Commissioner, People of God Community v. Commissioner, and P.L.L. Scholarship Fund, v. Commissioner. Those cases involved organizations engaged primarily in fund raising activities through motto games. The courts held that neither organization qualified for exemption under section 501(c)(3) of the Internal Revenue Code because they were not operated exclusively for exempt purposes.

Because a substantial part of your activities is not in furtherance of an exempt purpose, we have determined that you are not operated exclusively for an exempt purpose pursuant to section 501(c)(3) of the Internal Revenue Code and section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

ORG does not have any other activity besides the charitable gaming sessions. The workforce at the gaming sessions is made up of people from other organizations. These other organizations worked motto in exchange for compensation. ORG was basically running a turn-key-operation for other organizations in the _____ area. These other organizations worked motto in exchange for compensation. This direct compensation based off of the net receipts per motto is a form of inurement.

We have determined that a substantial amount of income from your motto operation inured to the private benefit of your motto workers.

In addition, by engaging in substantial activities that serve private rather than public interests, you are not operated exclusively for one or more exempt purposes pursuant to section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations. (See Church in Boston v. Commissioner and World Family Corp. v. Commissioner.)

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

The fact the ORG is shutting down and have turned in their gaming license is irrelevant. During the periods under examination, 100% of the activities were related to a non-exempt purpose (motto and pull-tabs) and 100% of the income was related to a non-exempt purpose (motto and pull-tabs).

ORG's tax exempt status should be revoked effective January 1, 20XX.

Conclusion:

Based on the analysis of your activities and the sources and amounts of your gross income and expenses, we have determined that you no longer meet the requirements for exemption under section 501(c)(3) of the Internal Revenue Code.

You are operated similar to the organizations described in Make a Joyful Noise v. Commissioner, People of God Community v. Commissioner, and P.L.L. Scholarship Fund, v. Commissioner. Those cases involved organizations engaged primarily in fund raising activities through motto games. The courts held that neither organization qualified for exemption under section 501(c)(3) of the Internal Revenue Code because they were not operated exclusively for exempt purposes.

Because a substantial part of your activities is not in furtherance of an exempt purpose, we have determined that you are not operated exclusively for an exempt purpose pursuant to section 501(c)(3) of the Internal Revenue Code and section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations.

We have determined that a substantial amount of income from your motto operation inured to the private benefit of your motto workers.

By engaging in substantial activities that serve private rather than public interests, you are not operated exclusively for one or more exempt purposes pursuant to section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations. (See Church in Boston v. Commissioner and World Family Corp. v. Commissioner.)

Based on the facts, law and conclusions cited above, we have determined that you no longer qualify for exemption under section 501(c)(3) of the Internal Revenue Code.

The tax exempt status of ORG will be revoked effective January 1, 20XX.

ORG will be responsible for filing Form 1120 for all periods after January 1, 20XX.

ORG is also responsible for filing the associated Forms 730, 11-C, and any other tax return that maybe required.

Alternative Position:

1. In the event that ORG remains tax-exempt, is the motto income considered unrelated business income (UBI)?
2. In the event that ORG remains tax-exempt, is the pull-tab income considered unrelated business income (UBI)?

Facts:

Same as above

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
E xplanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

Law:

Section 511(a) of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c), which includes section 501(c)(3).

Section 512(a)(1) of the Code provides that as a general rule, except as otherwise noted, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 512) regularly carried on by it, less certain allowable deductions and modifications.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of the charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Section 513(a)(1) of the Code provides that the term unrelated trade or business does not include any trade or business in which substantially all the work in carrying on such trade or business is performed for the organization without compensation.

Section 1.513-1(a) of the regulations provides that gross income of an exempt organization subject to tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that, in general, any activity of an exempt organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162 of the Code is a trade or business for purposes of sections 511-513. Further, the term "trade or business" generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether gross income from a trade or business is "regularly carried on" within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question-- the activities, that is, of producing or distributing the goods or performing the services involved-and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

Section 1.513-5 (a) *In general.* —Under section 513(f), and subject to the limitations in paragraph (c) of this section, in the case of an organization subject to the tax imposed by section 511, the term "unrelated trade or business" does not include any trade or business that consists of conducting motto games (as defined in paragraph (d) of this section).

Section 1.513-5 (b) *Exception.* —The provisions of this section shall not apply with respect to any motto game otherwise excluded from the term "unrelated trade or business" by reason of section 513(a)(1) and §1.513-1(e)(1) (relating to trades or businesses in which substantially all the work is performed without compensation).

Section 1.513-5 (c) *Limitations (1) Motto games must be legal.* —Paragraph (a) of this section shall not apply with respect to any motto game conducted in violation of State or local law. (2) *No commercial competition.* —Paragraph (a) of this section shall not apply with respect to any motto game conducted in a jurisdiction in which motto games are ordinarily carried out on a commercial basis. Motto games are "ordinarily carried out on a commercial basis" within a jurisdiction if they are regularly carried on (within the meaning of §1.513-1(c)) by for-profit organizations in any part of that jurisdiction. Normally, the entire State will constitute the appropriate jurisdiction for determining whether motto games are ordinarily carried out on a commercial basis. However, if State law permits local jurisdictions to determine whether motto games may be conducted by for-profit organizations, or if State law limits or confines the conduct of motto games by for-profit organizations to specific local jurisdictions, then the local jurisdiction will constitute the appropriate jurisdiction for determining whether motto games are ordinarily carried out on a commercial basis.

Section 1.513-5 (d) *Motto game defined.* —A motto game is a game of chance played with cards that are generally printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern such as a horizontal, vertical, or diagonal line, or all four corners. The first participant to form the preselected pattern wins the game. As used in this section, the term "motto game" means any game of motto of the type described above in which wagers are placed, winners are determined, and prizes or other property is distributed in the presence of all persons placing wagers in that game. The term "motto game" does not refer to any game of chance (including, but not limited to, keno games, dice games, card games, and lotteries) other than the type of game described in this paragraph.

Issue 1:

Is the motto operation of ORG (ORG) considered unrelated business income (UBI)?

Taxpayer's Position:

The taxpayer's position is unknown.

Government's Position:

Form 886A	Department of the Treasury - Internal Revenue Service	Schedule No. or Exhibit
Explanation of Items		
Name of Taxpayer ORG		Year/Period Ended 12/31/20XX 12/31/20XX

The motto operation is considered a source of UBI. The exclusion under Section 513(f) does not apply since the motto operation was conducted with compensated labor which is a violation of state law.

The motto operations are a business, it was regularly carried on, and it is not related to the exempt purpose. In addition, the volunteer labor exclusion does not apply since substantially all of the work force was compensated. This is apparent with the checks written to other organizations in exchange for providing motto workers.

Conclusion:

The motto operation is considered a source of UBI.

Issue 2:

Is the pull-tab operation of ORG considered unrelated business income (UBI)?

Taxpayer's Position:

The taxpayer's position is unknown.

Government's Position:

The pull-tab operation is a source of UBI. The activity was a business, it was regularly carried on, and it is not related to the exempt purpose. In addition, the volunteer labor exclusion does not apply since substantially all of the work force was compensated. This is apparent with the checks written to other organizations in exchange for providing motto workers.

Conclusion:

The pull-tab operation is considered UBI.